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IN THE

Supreme Court of the United States

OCTOBER TERM, 1954.

No. [redacted] 20

CORN PRODUCTS REFINING COMPANY,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

(Consolidated Proceedings.)

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE PETITIONER

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IN THE

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CORN PRODUCTS REFINING COMPANY,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

(Consolidated Proceedings.)

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE PETITIONER

OPINIONS BELOW

The opinion of the United States Court of Appeals (R. 293) is reported at 215 F. (2d) 513.

The opinion of The Tax Court for the year 1940 appears in 16 T.C. 395 (R. 22). The opinion of The Tax Court for the year 1942 was a memorandum decision, dated June 30, 1952 (R. 201).

JURISDICTION

The judgment of the Circuit Court of Appeals was entered on August 25, 1954 (R. 301). A Petition for Rehearing was denied by that Court on the 27th day of September, 1954. The Petition for a Writ of Certiorari was filed on the 9th day of November, 1954, and was granted on January 10, 1955. The jurisdiction of this Court rests on 28 U. S. Code 1254(1).

STATUTES INVOLVED

The statutory provisions involved are as follows:

With respect to Question I, Section 117 of the Internal Revenue Code of 1939;

With respect to Question II, Section 118 of the Internal Revenue Code of 1939.

These provisions are printed in Appendix A, *infra*, pages 53 through 68.

QUESTIONS PRESENTED

Two questions are presented for the review of this Court in accordance with its order granting the Petition for Certiorari:

I

Commodity Futures Transactions

Are transactions in commodity futures, which are not "true hedges", capital asset transactions and thus subject to the provisions of Section 117 of the Internal Revenue Code of 1939, or do such transactions give rise to ordinary income and ordinary deductions?

II

Wash Sales

Are commodity futures "securities" within the meaning of Section 118 of the Internal Revenue Code of 1939 and thus subject to the "wash sales" provisions thereof?

The answers to Question I and Question II will affect, for the years 1940 and 1942, the amount of Petitioner's excess profits credit (based on income), its net income and its income and excess profits taxes.

The consequences are such under the excess profits tax law in the computation of the excess profits credit that Respondent is taking a position diametrically opposed to the position he would ordinarily take for normal income tax purposes. This inversion can be readily seen from the fact that:

(a) Respondent is contending on Question I that where there are losses on commodity futures transactions, the losses are ordinary losses and deductible without limitation; and

(b) Respondent is contending on Question II for a *limitation* of the scope of the "wash sales" provision of the Internal Revenue Code.

Petitioner, on the other hand, is taking the contrary position in its own interest, which happens to be clearly in the interest of the greater public revenue.

STATEMENT

The facts with respect to the issues are as follows:

I

Commodity Futures Transactions

The Petitioner, Corn Products Refining Company, is a nationally-known manufacturer of products made from corn. Its average annual grind or consumption of raw corn was in excess of 35,000,000 bushels in the years 1937 through 1940 and up to over 60,000,000 bushels in 1942 (Exhibit 2-B, R. 224, 231).

Petitioner's major products were corn starch, corn syrup, and corn sugar. By-products, which were substantial contributors to Petitioner's income, were corn feed and corn oil (R. 22, 65). All of its products competed extensively with products made from other raw materials. Most importantly, for the instant case, Petitioner's refined corn sugar, cerelose, competed with cane and beet sugar.

In 1934 and 1936, severe droughts occurred in the Mid-West corn belt, and the price of corn rose sharply. As a result, Petitioner found it impossible to compete profitably with cane and beet sugar in the

sales of its corn sugar, and "lost money on each sale" (R. 51).

In an attempt to meet this condition, Petitioner in 1937 evolved a program whereby it would buy corn futures whenever it considered the price of corn low, and would gradually establish a substantial long futures position in the neighborhood of 12,000,000 bushels (R. 50, 52). The idea was to build this position during the year until it could be ascertained with some degree of certainty that no drought was likely to occur, and, if that were the likelihood, the long position would then be liquidated in part, usually in July, when crop conditions could be reasonably forecast.

The program was never put into full operation although substantial quantities of corn futures were acquired. In 1939, the outbreak of the European War made this plan unnecessary because of the attendant rise of the price of cane and beet sugar (R. 52, 156).

Petitioner's corn futures were acquired and disposed of, with minor exceptions, through brokers on regulated exchanges (R. 32). They were not sold to customers in the ordinary course of its business (R. 32). They were not included in inventory (R. 81). They were not subject to depreciation (R. 33).

The policy of the Petitioner was to sell for shipment within thirty days (R. 67) against "stocks of

finished goods" and storage corn (R. 60). The purpose and effect of this policy can be seen from chart at page 9, the factual material for which comes from R. 33 and 224 and Exhibits 6F (R. 49, 95-97) and 7G (R. 49, 101) for the year 1940, 6F (R. 246, 267, 268) and 7G (R. 247, 270) for 1942.

Mr. Praeger, Petitioner's General Purchasing Agent, testified that Petitioner's storage capacity was 2,300,000 bushels (R. 50). As to purchases of greater quantities, it was cheaper to purchase futures than corn since storage charges would have to be paid.

Mr. Praeger testified that the purpose of the purchase of futures was to accumulate a "long" position of approximately 12,000,000 bushels (R. 52). By definition, this meant corn, stocks and futures in excess of orders (R. 60). Since the orders were nearby (thirty days in general), they were first applied against corn and stocks (R. 60). The statistical summary on page 8 and the chart at page 9 shows that the amount of orders which could at any time have been applied to offset futures was insignificant. In general, the futures matured well after orders on hand. Exhibit 3C (R. 33, 37).

STATISTICAL SUMMARY OF CHART

Orders and Stocks from Exhibits 6-F, 1940 (R. 49, 95-97); 1942 (R. 246, 267-269)
Stocks from Exhibits 7-G, 1940 (R. 49, 101); 1942 (R. 247, 271)
Storage Capacity: 1940 (R. 33); 1942 (R. 224)

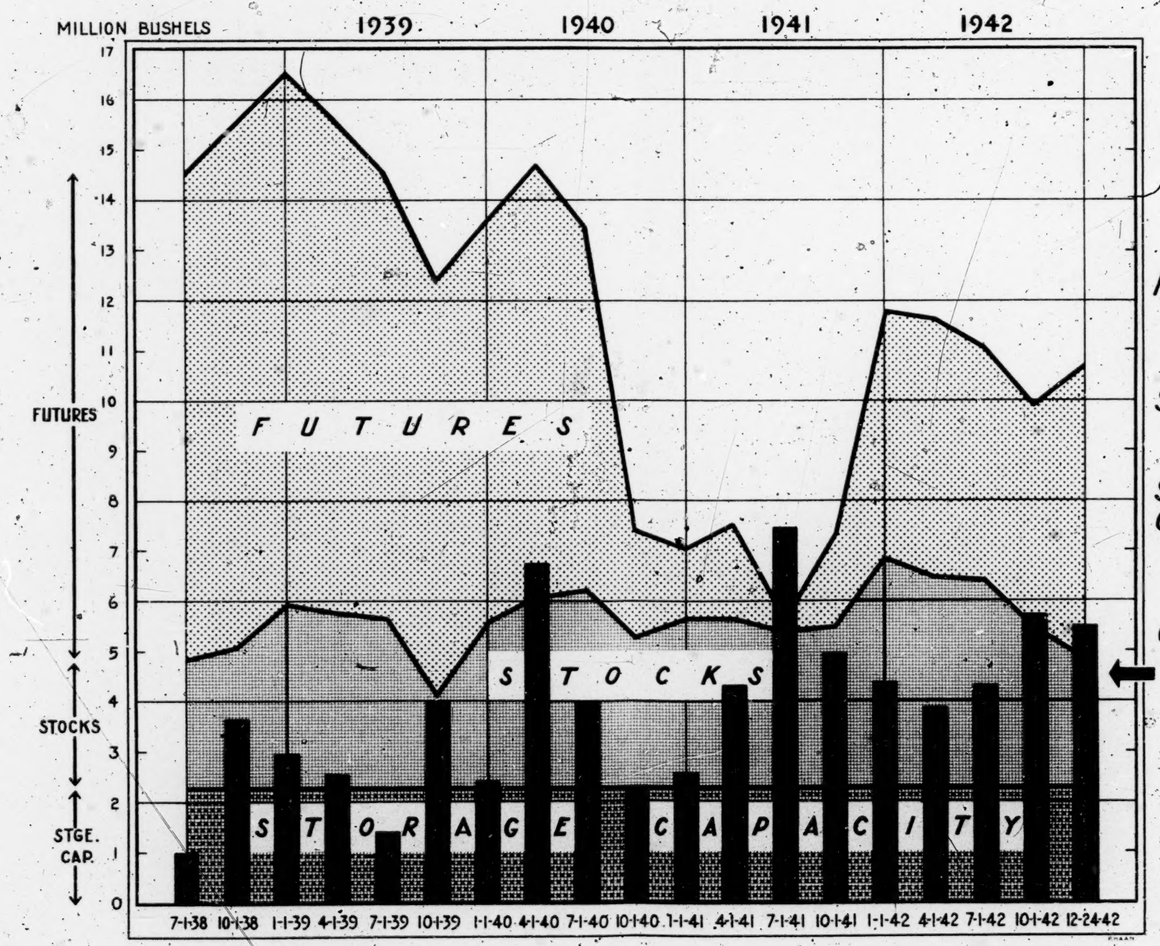
Thousands of Bushels

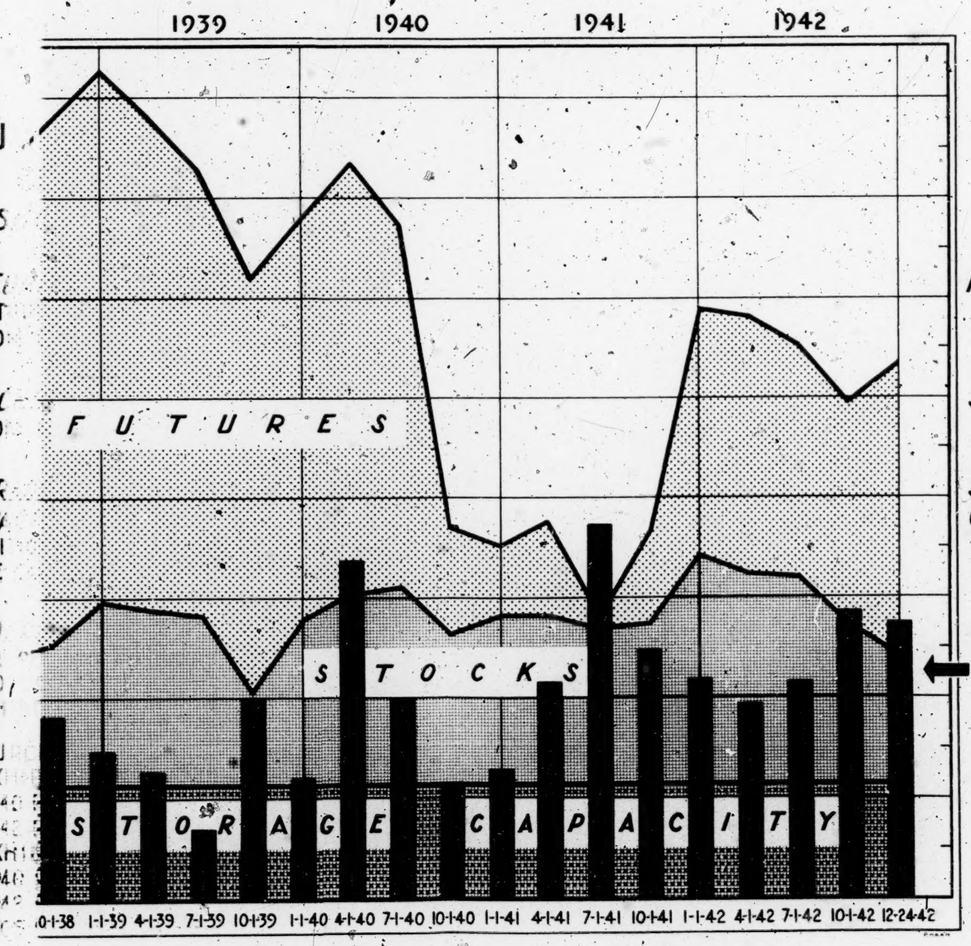
	7/1/38	10/1/38	1/1/39	4/1/39	7/1/39
Orders	985	3635	2950	2550	1405
Futures	9700	10450	10600	9800	8850
Stocks	2565	2820	3655	3505	3420
Storage Capacity	2303	2303	2303	2303	2303

	10/1/39	1/1/40	4/1/40	7/1/40	10/1/40
Orders	4010	2420	6770	4015	2225
Futures	8250	8050	8650	7200	2100
Stocks	1890	3270	3800	3965	3000
Storage Capacity	2303	2303	2303	2303	2303

	1/1/41	4/1/41	7/1/41	10/1/41	1/1/42
Orders	2550	4280	7470	4950	4350
Futures	1400	1900	300	1850	4950
Stocks	3330	3340	3070	3210	4560
Storage Capacity	2303	2303	2303	2303	2303

	4/1/42	7/1/42	10/1/42	12/24/42
Orders	3830	4315	5694	5495
Futures	5120	4650	4450	5850
Stocks	4220	4160	3178	2534
Storage Capacity	2303	2303	2303	2303





CUMULATIVE CHART SHOWING:

FUTURES - CORN FUTURES OWNED FROM EXHIBIT 7-G

STOCKS - INVENTORY FROM EXHIBIT 6-F

STORAGE CAPACITY - PETITIONER'S STORAGE CAPACITY

ORDERS - ORDERS FOR PETITIONER'S PRODUCTS FROM EXHIBITS 6-F & 7-G

SOURCE:
EXHIBIT 6-F
1940 R.49, 95-97
1942 R.246, 267-269
EXHIBIT 7-G
1940 R.49, 101
1942 R. 247, 271
STGE. CAP.. R.33, 224

Orders were evidenced by a form of contract (Ex. 10, R. 67, 105). The price was named, but provision was made that if the price in effect on the day of delivery were lower, the buyer by contract was to have the advantage of such lower price (Ex. 10, R. 67, 105, 203).

Petitioner also had the policy of permitting its customers to cancel their orders in their discretion (R. 203). Cancellations were frequent, unpredictable, and at times substantial (R. 69).

Petitioner was not protected against contract cancellations and price declines which the expert witness Henry said made a true hedge impossible (R. 67, 91, and 92) (Ex. 7G, R. 49, 91).

II

Wash Sales

A corn future dealt with on a regulated exchange (only such are involved in this case) consists of a document or instrument evidencing a right to buy 5,000 bushels of corn, or some multiple thereof, of a stated quality, at a stated price, upon delivery during a stated month in the future (R. 89, 90, 92). All such futures mature within eleven months. Months of maturity of such instruments are May, July, December, and, occasionally, March and October (R. 54, 204), although this Petitioner sold most futures prior to maturity and bought others to replace or extend them.

There is no difference between one corn future and another except as to date of maturity and obligor (R. 90). The seller or purchaser, as the case may be, is not known to the other party buying or selling and, consequently, their identities are of no economic significance. They are dealt with on regulated exchanges, such as the Chicago Board of Trade (R. 89, 90, 91). They are purchased and sold through brokers (R. 89, 90). Each future is evidenced by a writing (Ex. 14, R. 89, 151). Futures are dealt in on margin (R. 94).

Stocks, bonds, and commodity futures are all listed and traded on the Chicago Board of Trade (R. 94). As far as a floor broker is concerned, there is no essential difference between trading in stocks and bonds on margin and trading in futures on margin since all are negotiable (R. 94).

SUMMARY OF ARGUMENT

1. Corn futures contracts are capital assets. They fall expressly within the definition of capital assets in Section 117(a) of the Internal Revenue Code of 1939. None of the exclusions in that section applies to them. Any gain or loss resulting from their sale or exchange should be treated as capital gain or capital loss as provided in Section 117. In any event, Petitioner's transactions in corn futures were not "true" hedges and therefore do not come within the so-called hedging exception to Section 117.

2. Corn futures traded on regulated exchanges are "stocks or other securities" as that term is used in Section 118 of the Internal Revenue Code of 1939 and are subject to the "wash sales" provision of such section.

ARGUMENT

I

Petitioner's Commodity Futures Transactions were Capital Asset Transactions under the Internal Revenue Code of 1939.

The question of the proper tax treatment of commodity futures transactions is one of first impression for decision by the Supreme Court of the United States. This Court has considered the nature of commodity futures trading, but not its tax consequences in *United States* v. *New York Coffee & Sugar Exchange, Inc.*, 263 U. S. 611 (1924) and *Chicago Board of Trade* v. *Christie Grain and Stock Company*, 198 U. S. 236 (1904). The tax consequences of commodity futures transactions have received considerable attention in the lower courts and were once presented to this Court on a petition for certiorari in *Commissioner* v. *Farmers & Ginners Cotton Oil Co.*, 120 F. (2d) 772, certiorari denied, 314 U. S. 683 (1941).

Petitioner contends that its transactions in commodity futures gave rise to capital gains and losses, not to ordinary gains and losses.

A. Section 117 of the Internal Revenue Code Governs Petitioner's Commodity Transactions.

The comprehensive provisions of Section 117 of the Internal Revenue Code of 1939, in effect during the tax years 1940 and 1942, which are pertinent here, set forth the treatment to be accorded to the results of taxable sales and exchanges of "capital assets". A reading of the section (Appendix A, pp. 53 to 58) will convince that, taken as a whole, it provides a specific, integrated, coherent and total scheme for the treatment of such sales or exchanges.

Section 117(a), insofar as it is relevant here, defines the term "capital assets" as follows:

> "(1) *Capital Assets.*—The term 'capital assets' means property held by the taxpayer (whether or not connected with his trade or business), but does not include stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business, or property, used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 23(l); * * * "

Under this statutory definition all types of property are "capital assets" unless they fall within a spe-

cific exclusion set forth in the definition. This is recognized by the Commissioner's Regulations (Regulations 103, Section 19.117-1) which state:

> "The term 'capital assets' includes all classes of property not specifically excluded by section 117(a)(1)."

It is clear that Petitioner's corn futures are "capital assets" under the statutory definition. They are property. They do not come within any of the specific exclusions set forth in the section in that:

(1) They are not "stock in trade of the taxpayer".

(2) They are not "other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year".

(3) They are not "property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business".

(4) They are not "property, used in the trade or business, of a character which is subject to the allowance for depreciation provided in Section 23(l)".

It is clear that Section 117 includes Petitioner's commodity futures transactions. The Section specifically includes within its purview *all sales and exchanges* of "capital assets" except those non-taxable reorganization exchanges expressly exempted therefrom by Congress in Section 112—none of the provisions of which is relevant here.

Where Congress has addressed itself so specifically, so unambiguously, and so comprehensively to the problem of "capital assets", as it has in Section 117, the question of the tax treatment of Petitioner's commodity futures, which are clearly "capital assets" within the meaning of the section, should be referred to that section and to the plain meaning of the words of that section alone. Accordingly, Petitioner's commodity futures transactions should be treated for tax purposes as capital asset transactions.

B. Petitioner's Commodity Futures Transactions Do Not Fall Within the So-called "Hedging Exception" to Section 117.

(1) Development of the "Hedging Exception"

Before the passage of the Revenue Act of 1934, the statutory definition of a capital asset excluded any property held for less than two years. Since commodity futures transactions were always required to be closed out in a shorter period than two years under the rules of the various commodity exchanges, no question of their tax treatment as capital assets arose.

The Revenue Act of 1934, however, effected a major change in the definition of capital assets. It completely abolished the time element as a basis of distinction between capital and non-capital assets, and set forth a new definition of capital assets which was essentially the same as that quoted above (p. 13). Commodity futures fell literally and precisely within this statutory definition of capital assets.

Thereupon, the Treasury Department in 1936 issued General Counsel's Memorandum No. 17322 (XV-2 C. B. 151).

This G. C. M. divided all commodity futures transactions (cotton was the commodity specifically involved) into two types, *speculative* and *hedging*, and expressed the opinion that "hedging transactions are essentially to be regarded as insurance rather than a dealing in capital assets" although the "provisions pertaining to capital gains and losses govern gains or losses on futures contracts which are speculative." It stated (p. 152):

> "Such hedges, which eliminate speculative risks due to fluctuations in the market price of cotton and thereby tend to assure ordinary operating profits, are common trade practices and are generally regarded as a form of insurance (the only kind available as protection against such risks) necessary to conservative business operation. Where futures contracts are entered into only to insure against the above-mentioned risks inherent in the taxpayer's business, the hedging operations should be recognized as a legitimate form of business insurance. As such, the cost thereof (which includes losses sustained therein) is an ordinary and necessary expense deductible under section 23(a) of the Revenue Act of 1934 and corresponding provisions of prior Revenue Acts."

And so the concept of hedging was imported into the problem of the tax treatment of the results of the

purchase and sale of commodity futures, a problem for which Congress had provided a clear and complete set of rules to deal with in Section 117—and this without reference to "hedging".

It cannot be said that Congress was unaware of hedging transactions and their impact taxwise. In Section 502(c) of 1939 I. R. C. Congress made a specific exception for hedging transactions in its definition of personal holding company income. Yet, while Congress has from time to time amended Section 117(a) to provide additional exclusions to the definition of "capital assets", it has never made "hedging" an exclusion.[1]

Following the G. C. M. a number of cases were decided wherein the concept of hedging as an exception to Section 117 was applied to the question of the proper tax treatment of the results of purchases and sales of commodity futures.[2]

In all of these cases where the courts found that a hedge existed, they treated the taxpayer's gains and

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[1] By Section 210(c) of 1950 I. R. C., Congress amended Section 117(a) to exclude copyrights, literary, musical and artistic compositions under specific circumstances. In 1954 I. R. C., Congress added a further exclusion in Section 1221, successor to Section 117(a), with respect to accounts or notes receivable acquired in the ordinary course of trade or business. In addition, when Congress in the Revenue Act of 1942 saw fit to make a qualified exclusion out of real property used in a taxpayer's trade or business, in a most intricate bit of lawmaking it amended Section 117(a) to make this sort of property an exclusion and added Section 117(j) to set limitations and conditions on the exclusion.

[2] See cases cited at page 22.

losses as ordinary; where they found that a hedge did not exist, they treated the taxpayer's gains and losses as capital.

In none of these cases was the question of the validity of hedging as an exception to Section 117 raised. This is understandable in view of the fact that in all these cases the taxpayers were seeking to take advantage of the G. C. M. so as to be able to *deduct losses in full* on their commodity futures transactions. The Commissioner of Internal Revenue on the other hand apparently considered himself bound by the G. C. M.

In any event, this Court has never decided the question of the validity of the so-called "hedging exception" to Section 117, but Petitioner in the instant case squarely raises the question and seeks a decision on the point.

(2) Petitioner's Commodity Futures Transactions Were Not Hedges

(a) *The Definition of a Hedge Generally*

There are many meanings of the term "hedge" in common usage.[3] The United States Secretary of Agriculture who exercises jurisdiction over Com-

[3] Webster's Dictionary contains some fifteen definitions. Quite commonly, one hears — "He is buying common stock as a hedge against inflation" or "How did he answer the question? He hedged."

modity Exchanges has recently stated in one of his decisions[4] that

> "* * * the hedge is used to insure processors against loss *due to price changes in commodities.* Its purpose is to insure processing profit. Its object is not to return a speculative profit, for the reason that any profit derived on the futures merely equalizes or offsets a loss which has been incurred on a transaction or market position in the cash commodity market. The cash market transaction and the exchange transaction are complementary. By means of the futures trading, the hedger passes on to others a market risk, that is, the risk of price change in the commodity. Accordingly, *an essential characteristic of true hedging is a price commitment with respect to the cash commodity or product which is protected by a futures transaction.* In other words, a futures sale is a hedge to the extent that the trader owns or purchases an equivalent amount of the cash commodity or products or by-products thereof and *a futures purchase is a hedge to the extent that the trader has contracts for forward sales of the cash commodity or products or by-products of the commodity at fixed prices.*" (Emphasis supplied in part.)

This Court has on occasion defined the term "hedging". In *Chicago Board of Trade* v. *Christie*

[4] *In re Corn Products Refining Company*, 13 Agric. Dec. 1117, at p. 1130 (1954).

Grain and Stock Company, 198 U. S. 236 (1904), this Court said (p. 249):

> "Hedging, * * *, as it is called, is a means by which collectors and exporters of grain or other products, and manufacturers who make contracts in advance for the sale of their goods, secure themselves against the fluctuations of the market by counter contracts for the purchase or sale, as the case may be, of an equal quantity of the product, or of the material of manufacture."

In *Brown* v. *Thorn,* 260 U. S. 137 (1922), this Court said (pp. 139, 140):

> "* * * hedging being explained as a means by which manufacturers and others who have to make contracts of purchase or sale in advance secure themselves against the fluctuations of the market by counter contracts."

In *United States* v. *New York Coffee & Sugar Exchange, Inc.,* 263 U. S. 611 (1924), this Court defined hedging as insurance against loss by unfavorable changes in price at the time of actual delivery of what is sold or bought in a business.

Incidentally, in the last case, this Court classified persons who engage in commodity futures transactions in three categories, as follows (p. 619):

> "Those who deal in 'futures' are divided into three classes: First, those who use them to hedge,

i. e., to insure themselves against loss by unfavorable changes in price at the time of actual delivery of what they have to sell or buy in their business; second, legitimate capitalists, who exercising their judgment as to the conditions, purchase or sell for future delivery with a view to profit based on the law of supply and demand; and, third, gamblers, or irresponsible speculators, who buy or sell as upon the turn of a card."

It will be remembered that G. C. M. 17322 mentioned only two classes of persons who engage in commodity futures transactions, to wit, "hedgers" and "speculators". It is Petitioner's contention that it was in the "legitimate capitalist" class described by this Court, the very class which the G. C. M. fails to mention at all.

None of the foregoing definitions of hedging was enunciated in connection with a tax case.

(b) *The Definition of Hedging in Tax Cases. The Criterion of the "True Hedge".*

Following the principle set forth in G. C. M. 17322, the courts, in defining a hedge for the tax purpose of determining whether or not commodity futures transactions were capital transactions, at an early date settled on the concept of the "true hedge" as the criterion. This criterion has been scrupulously applied until the instant case.

The principal cases and the findings therein were:

Name and Citation	Finding
Ben Grote, 41 B. T. A. 247 (1940).	"Hedge": ordinary loss allowed.
Commissioner v. *Farmers & Ginners Cotton Oil Co.,* 120 F. (2d) 772 (5th Cir. 1941), cert. denied, 314 U. S. 683 (1941).	No "true hedge": capital loss.
Kenneth S. Battelle, 47 B. T. A. 117 (1942).	"Hedge": ordinary loss allowed. Also no "hedge": capital loss.
Tennessee Egg Co., 47 B. T. A. 558 (1942).	No "hedge": capital loss.
Trenton Cotton Oil Co. v. *Commissioner,* 147 F. (2d) 33 (6th Cir. 1945), affirming T. C. Memo Op. (Dec. 28, 1943).	No "true hedge": capital loss.
Estate of Dorothy Makransky, 5 T. C. 397 (1945), aff. 154 F. (2d) 59 (3rd Cir. 1946).	No "true hedge": capital loss.
Stewart Silk Corp., 9 T. C. 174 (1947).	"True hedge": ordinary loss allowed.
Fulton Bag & Cotton Mills, 22 T. C. 1044 (1954).	"True hedge": ordinary loss allowed.

Thus, since all cases involved losses on commodity futures transactions, not gains, when the courts found a "hedge" or later a "true hedge", the taxpayer won. When the courts found no "hedge" or no "true hedge", the taxpayer lost.

The definition of a hedge—a "true hedge", most frequently quoted in these cases is that contained in *Commissioner* v. *Farmers & Ginners Cotton Oil Co.*, 120 F. (2d) 772 (5th Cir. 1941), where the Court said (p. 774):

> "A hedge is a form of price insurance; it is resorted to by businessmen to avoid the risk of changes in the market price of a commodity. The basic principle of hedging is the maintenance of an even or balanced market position. To exercise a choice of risks, to sell one commodity and buy another, is not a hedge; it is merely continuing the risk in a different form."

A particularly lucid and articulate definition of a "true hedge"[6] is set forth in the opinion of the Court of Appeals in the instant case (R. 295):

> "Hedging is a method of dealing in commodity futures whereby a person or business protects itself against price fluctuations at the time of delivery of the product which it sells or buys. *United States* v. *New York Coffee & Sugar Exchange*, 263 U. S. 611. A typical example of hedging occurs when a manufacturer of grain products

[6] So denominated in the Court's opinion. (R. 297).

seeks to stabilize its costs against fixed forward sales prices. Having contracts for the delivery of its grain products to its customers at fixed prices, the manufacturer seeks to set the cost of its related inventory item, grain, by entering into futures contracts for the purchase of it. By so doing the manufacturer may later obtain the necessary grain at a price properly related to the already fixed selling price of his manufactured product and, so far as commodity costs are concerned, the profit from manufacturing is insured."

It should be noted that while in the earlier cases the courts used the term "hedge" whereas later decisions used the term "true hedge", apparently no difference in concept was intended. Both terms, in fact, described the same type of balanced insuring transactions.

From the foregoing cases and discussion the following principles (in so far as they are relevant here) of "hedging", *i. e.*, "true hedging" can be extracted:

(i) The desirability of hedging stems from the fact that businessmen sometimes make firm commitments for the sale of their manufactured products in advance of making commitments for the purchase of the raw materials from which they are to be manufactured, and, as a consequence, face the risk of rising raw material prices threatening whatever profit might be made on the sales of the manufactured products.

(ii) True hedging is profit insurance—*i. e.*, the relationship between the selling price of manufactured goods (for which there is a firm commitment) and the purchase price of raw materials (not as yet purchased) from which they are to be manufactured will be such that the difference between the two prices will be fixed and a profit will ensue.

(iii) True hedging may be also described as the elimination of the speculative risk of market fluctuations in the prices of manufactured goods (for which there is a firm commitment) and the raw materials (not as yet purchased) from which they are to be manufactured.

(iv) True hedging is accomplished by the acquisition and maintenance of a balanced position. Thus a true hedge may be defined as a balanced position.

(v) A balanced position means the acquisition of commodity futures in an amount roughly equivalent to the amount of commodities (not as yet purchased) needed to manufacture the finished goods in respect of which there are firm commitments at a firm price. Acquisition of the commodity futures takes place at or about the time the given commitments for finished goods are made, and the disposition of the commodity futures takes place at or about the time the actual commodities to be manufactured into finished goods are acquired.

(vi) To exercise a choice of risks to sell one commodity and buy another is not a "true hedge"; it is merely continuing the risk in a different form.

The operation of these principles can clearly be seen from one of the two type situations[7] involving hedging transactions set forth in G. C. M. 17322 referred to above. It was illustrated as follows:

"(2) The taxpayer makes contracts for future delivery of cotton goods, the manufacture of which will require more cotton than the amount on hand or the amount which can be immediately purchased advantageously. In order to secure protection against a rising cotton market during the months that intervene between the date of the order for cotton goods and the agreed delivery date, the taxpayer, at the same time the above orders are taken, enters into futures purchase contracts for cotton in amounts necessary to provide the desired protection. As the taxpayer from time to time buys spot cotton for the manufacture of the goods specified in the above orders, the futures purchase contracts are disposed of by futures sale contracts which serve as offsetting transactions closing out the futures purchase contracts."

In the G. C. M. illustration, the taxpayer fixes the price of the cotton goods he sells for future delivery

[7] The other type situation, i. e., the sale of commodity futures against inventory, is not involved here.

on the basis of present raw cotton prices, the price of the cotton goods allowing for his manufacturing profit. In the interval between the time when he makes the contract for the sale of cotton goods and the time when he will acquire the actual raw cotton to manufacture the cotton goods, the price of raw cotton may rise or fall. If it rises, he will lose some or all of his estimated profit. If it falls, he will make an even larger profit than he estimated. To eliminate this speculation, he buys cotton futures in the amount of raw cotton that he needs to fill his contract. This is a balanced position, the cotton futures balancing the raw cotton he will need. Then if the price of raw cotton advances by the time he needs it to fill his cotton goods contract, the price of cotton futures, paralleling the price of raw cotton, will advance, too. So, as he buys the raw cotton that he needs to fill his cotton goods contract, he sells his cotton futures. Thus the amount of the profit which he estimated he would make on his cotton goods contract but which he didn't make due to the rise in the price of raw cotton will have been offset in an equal amount by the profit he will make on his futures transaction. In this way, his estimated profit is insured. If the price of raw cotton declines, he will have a loss on his futures transaction, but this will be offset by an equal amount of increased profit on his cotton goods contract. Again, his estimated profit is insured. Insurance is effected whether the price of raw cotton rises or declines, and all speculative risk of fluctuations in the price of raw cotton

is eliminated. It is the balanced position that insures and protects the profit. This is a hedge; a "true hedge".

(c) *Petitioner's Commodity Futures Transactions Were Not "True Hedges".*

Petitioner's commodity futures transactions were not "true hedges" within the foregoing principles. The salient facts of the instant case clearly show this. They are:

(i) At almost all times Petitioner had on hand sufficient corn and manufactured inventory (stocks) to meet all of its customers' orders (Chart, p. 9). Thus, in respect of its commitments, there was no speculative risk of the fluctuation of the market price of raw material to be eliminated. There was no position to be balanced. Under such circumstances, Petitioner's corn futures purchases were not needed to, and could not possibly, hedge anything.

(ii) The time and amount of Petitioner's purchases of corn futures had no relationship to the time and amount of orders for the sale of its products. Petitioner's plan in respect of its corn futures purchases was to acquire a long futures position of approximately 12 million bushels of corn. There was no attempt to tie purchases of corn futures to orders. There was no attempt to acquire or maintain a balanced position. The

Chart (p. 9) shows this quite graphically. Significantly at the time (July 1, 1941) when Petitioner had the largest amount of orders, its corn futures position was the smallest.

(iii) Petitioner, under its sales policy, in actuality had no commitments for the sale of its products on which it could count. Customers were permitted to, and did, cancel orders in their discretion and, as a result, cancellations were frequent, unpredictable, and substantial. Without firm forward sales commitments, there was nothing to hedge.

(iv) Petitioner had no firm price in sales contracts for its products which it could protect by purchases of corn futures. Its prices were subject to decline to the price on the date of delivery (Exh. 10, R. 67, 105). Without a firm sales price there could not be that insurance of the relationship between the price of manufactured goods and the raw materials from which they are manufactured which is the essence of a "true hedge."[8]

In addition, Petitioner's refined corn sugar, one of its major products, was in direct competition with cane and beet sugar and price protection could have been obtained by Petitioner only by sales of cane sugar futures correlated with purchases of corn futures. But the record discloses no sales of cane sugar futures by Petitioner.

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[8] *In re Corn Products Refining Company*, 13 Agric. Dec. 1117 (1954).

Under such circumstances, corn futures purchases could insure no price relationship, no profit. Therefore there could not be a true hedge. Moreover, a hedge by the sale of sugar futures assumes firm commitments for the sale of Petitioner's products, a firm price in respect of such commitments, and some tie as to time and amount of purchases of corn futures with sales commitments. None of these assumptions is true.

(v) The explanation of Petitioner's acquisition of corn futures lay not in a desire to hedge, but in the following facts set forth in the record. The experience of Petitioner with the droughts of 1934 and 1936 made it fearful that the price of corn would rise precipitously due to short supply. It feared the possibility of a price rise more than that of a price decline. Consequently, Petitioner was unwilling to expose itself to the risk that the price of corn would rise, but was willing to expose itself to the risk that the price of corn would decline. With these factors in mind, and without regard to, or connection with, its sales commitments, Petitioner set about acquiring a long position of twelve million bushels of corn futures. Thus Petitioner was simply exercising its judgment in the purchase of corn futures. In so doing, it was merely exchanging one risk, *i. e.*, that the price of corn would rise, for another, *i. e.*, that the price of corn would decline. It was fixing the price of corn as far as the former risk was con-

cerned, but by so doing it exposed itself to the latter risk—against which it had no insurance whatsoever.

The conclusion is inescapable. Petitioner did not have a "true hedge" in its corn futures transactions. Both The Tax Court and the Court of Appeals concurred in this conclusion (R. 211 and 297).

In its purchases of corn futures it is clear that Petitioner was neither a hedger nor a speculator. It was in the position of the "legitimate capitalists, who exercising their judgment as to the conditions, purchase or sell for future delivery with a view to profit based on the law of supply and demand." *United States* v. *New York Coffee & Sugar Exchange, Inc.*, 263 U. S. 611 (1924).

(3) Action of the Courts Below

(a) *The Theory of The Tax Court in the Instant Case Is Untenable.*

The Tax Court in this case departed from the "true hedge" test which had been established by previous decisions. It found that Petitioner did not have a "true hedge". However, it refused to apply Section 117 and accord capital treatment to Petitioner's commodity futures transactions. In so doing, it introduced a new theory saying (R. 211):

"Although perhaps not conforming technically

to the definition of a hedge,[1] it seems indisputable as our findings show that petitioner's practice of purchasing corn futures was an integral part of its manufacturing business. *Ben Grote*, 41 B. T. A. 247; see *Kenneth S. Battelle*, 47 B. T. A. 117, 127. It would hence be anomalous to view them as purely speculative transactions of a capital nature,[2] . . .

"1 • • • to hedge, i. e., to insure themselves against loss by unfavorable changes in price at the time of actual delivery of what they have to sell or buy in their business; • • •' *United States* v. *New York Coffee & Sugar Exchange, Inc.*, 263 U. S. 611. See Patterson, 'Hedging and Wagering on Produce Exchanges,' (1931), 40 Yale L. J. 843, 846.

"2 • • • For example, if a manufacturer or processor of raw material is short on inventory and makes sales of his finished products for forward delivery, the appropriate hedging transaction in that instance would be the purchase of raw material futures at or about the time he makes the sale.' *Stewart Silk Corp.*, 9 T. C. 174, 178."

The theory of The Tax Court that Petitioner's transactions in corn futures, which are clearly "capital assets" under Section 117(a), cease to be capital transactions because they are a *practiced, integral part of its business* is indeed novel. Such a theory flies directly into the teeth of Section 117, which, by its terms, is expressly applicable to *all* non-specifically exempted transactions in *all* non-specifically excluded property, "whether or not connected with his [the taxpayer's] trade or business." There is nothing at all in the section that even remotely suggests that

transactions in "capital assets", regularly practiced as an integral part of a business, should be given ordinary gain or loss treatment, whereas purely speculative (or, the Court seems to indicate, perhaps isolated) transactions in "capital assets" should be given capital gain or loss treatment.

The theory presents a far more sweeping unwritten exception to Section 117 than that of hedging and one that is, to say the least, completely amorphous. Under it, Section 117 might not apply to any sales or exchanges of "capital assets" of a corporation for all such transactions might well be said to be an integral part of the corporate business. Certainly all such transactions might well be said to be non-speculative (and many of them might be non-isolated).

This is judicial legislation of the rankest sort. No justification for it is spelled out by the Court. No obscure intention of Congress is found. The theory seems to come out of thin air.

The Tax Court's theory was not supported by the Court of Appeals, and in its most recent pronouncement The Tax Court has gone back to the "true hedge" test. *Fulton Bag and Cotton Mills*, 22 T. C. 1044 (1954). In this case the Court said:

> "We have viewed the facts on the present record in light of the foregoing definition handed down in the *Farmers & Ginners Cotton Oil Co.*

> case, * * * and have concluded that the futures transactions entered into by petitioner during the fiscal years involved were *true hedging* operations to insure it against the risks of the cotton market. We have so found as a fact, and here hold, that the losses sustained by petitioner as a result thereof are deductible in full as ordinary losses or as cost of goods sold." (Emphasis supplied.)

(b) *The Theory of the Court of Appeals in the Instant Case Is Untenable.*

The Court of Appeals in the instant case also departed from the true hedge test but took an entirely different tack than the Tax Court. It found that Petitioner's commodity futures transactions did not constitute "true hedges", saying (R. 296):

> "The futures transactions of this petitioner, it is true, did not constitute what is known as *'true' hedging.* The *true hedge* can occur only when forward sales prices are fixed and the relation between commodity purchase and later sales price is insured against both increase and decrease of commodity prices. As the forward sales prices here were based mainly on the lower of order or market prices, the petitioner was protected only against increases in commodity prices and did not have the complete insurance of the *true hedge.*" (Emphasis supplied.)

Nevertheless, the Court held that Section 117 was not applicable to Petitioner's commodity futures transactions. To reach this conclusion, the Court first said that hedging was not an exception to Section 117 (R. 296):

> "The tax treatment of hedges, then, is not a 'judge-made exception' to Section 117(a); it is simply a recognition by the courts that property used in hedging transactions properly comes within the exclusions of the section."

The Court then said that while Petitioner's commodity futures transactions did not constitute true hedging, the property "was used for essentially the same purpose and in the same manner as in true hedging" (R. 297).

Then the Court concluded that "for the same reasons that the true hedge is not accorded capital treatment under Section 117(a), the kind of transactions with which we are now concerned are not to be regarded as capital ones either" (R. 297).

Petitioner agrees completely with the Court on two of its propositions: (i) that Petitioner's commodity futures transactions did not constitute "true hedging"; (ii) that hedging is not an exception to Section 117(a). These propositions, it is believed, have been amply demonstrated hereinabove.

However, the Court's proposition that while hedging is not an exception to Section 117(a), the prop-

erty used in hedging comes within the exclusions of the Section, is a proposition with which Petitioner disagrees.

What were the exclusions to Section 117(a) in the tax years 1940 and 1942? These were (and there were then no others):

(i) Stock in trade.

(ii) Inventory.

(iii) Property held for sale to customers.

(iv) Depreciable property used in business.

(v) Land used in business (after January 1, 1942).

Quite obviously Petitioner's commodity futures were neither (i), (iii), (iv) nor (v). The Court itself seems to think of Petitioner's commodity futures as (ii)—inventory.[9] But this is clearly wrong. Inventory is raw materials and supplies which will physically become a part of merchandise intended for sale. This is the Commissioner's own definition of inventory, promulgated pursuant to express Congressional mandate.[10] Petitioner's commodity futures were not that sort of property at all; they were not inventory. The Tax Court so held (R. 212) in the instant case, citing *Modesto Dry Yard Inc.*, 14 T. C. 374 (1950). Acq.

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[9] Actually the Court's opinion is not particularly clear on this point, but if it means anything, it must mean this.

[10] Section 22(c), Regulations 103, Sec. 19.22(c)-1.

The Court's proposition that, while Petitioner's commodity futures transactions did not constitute hedging, the commodity futures were "used for essentially the same purpose and in the same manner as in true hedging," is a proposition with which Petitioner disagrees.

What exactly do the words "for essentially the same purpose and in the same manner as in true hedging" mean in this connection? How can purpose or manner be relevant here? If vital elements of a hedge are lacking, as they are here, so that the transaction does not accomplish what a hedge is supposed to accomplish, should that transaction be treated as a hedge because of its purpose or manner?

The Court of Appeals seems to be saying that if a transaction is something like a hedge, even though it is not a hedge, it should be treated as a hedge.[11] But that does not seem to mean much of anything. How much like a hedge must a transaction be to be treated as a hedge, when in fact it is not a hedge and does not do what a hedge is supposed to do? The proposition raises many more questions than it answers.

Actually, the facts set forth above (pp. 28, 29, 30, 31) show that Petitioner's commodity futures transactions had no resemblance to a hedge. And the one single fact—that seems completely to have escaped the

[11] This was the gist of the Respondent's argument to the Court of Appeals.

Court's attention—which makes it abundantly clear that there was no such resemblance is this: *Petitioner at almost all times had sufficient corn and inventory on hand to meet all of its sales commitments (whatever their character because they were not firm).*[12] A glance at the chart (p. 9) will reveal this. There was, therefore, nothing to hedge.

Since Petitioner at almost all times had ample corn and inventory on hand to meet all sales commitments, Petitioner's commodity futures purchases had no balancing function at all. Under such circumstances it is clear that Petitioner was not hedging and did not have anything remotely resembling a hedge.

For these and other reasons set forth above, exception is taken to the Court of Appeals' conclusion, to wit: Petitioner's commodity futures transactions are excluded from capital gain and loss treatment pursuant to Section 117.

In passing it may not be amiss to observe that the tendency of The Tax Court and the United States Court of Appeals, Second Circuit, to depart from the definition of capital assets laid down by Congress in Section 117(a) is becoming more pronounced. See *Commissioner* v. *The Bagley & Sewall Co.* (C. A. 2nd,

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[12] Other facts negativing resemblance to a hedge are:

a. No tie in time and amount between purchases of commodity futures and sales commitments.
b. Lack of firm forward sales commitments.
c. Lack of firm sales price.
d. Uncontrollable price of sugar.

1955), — F. (2d) —, affirming 20 T. C. 983, where Judge Frank, in his dissenting opinion, pointed out:

> "The last clause of Section 117(a)(1) is illuminating: From 'capital assets' it excepts 'real property'—no other—if 'used in the trade or business of the taxpayer.' My colleagues, in effect, treat that clause as if it read 'any property used in the trade or business of the taxpayer.' This, I think, an improper judicial amendment of the statute.
>
> * * * *
>
> "My conclusion here derives from no ardent desire to add to the government's revenues by invariably interpreting statutes adverse to taxpayers; see, e. g., my dissenting opinion in *Babcock & Wilson* [sic] *Co. v. Pedrick*, 217 Fed. (2d) 654 (C. A. 2). But I think that courts should not allow what they deem fairness to taxpayers to override one of the most sensible canons of statutory construction, i. e., that, where a statute sets forth specific exceptions, further exceptions, by way of mere implication, are not permissible. Moreover, to hold for the taxpayer here may well mean unfairness to other taxpayers who, having acquired securities in situations just like this, but having made a gain on the sale of the securities, seek to claim that their taxable profits are capital gains, not ordinary income."

The extra-statutory deviations of The Tax Court and the Second Circuit with respect to Section 117(a)

have become notable. There is printed in Appendix B at page 69 a brief extract from a tax bulletin of Research Institute of America on the subject.

(4) A Case in Point

The case closest factually to the instant case is *Estate of Dorothy Makransky, et al.*, 5 T. C. 397 (1945), aff'd 154 F. (2d) 59 (3rd Cir., 1946). In that case, the taxpayer was engaged in the business of manufacturing men's suits from piece goods. Each fall its salesmen took firm orders for spring and summer delivery at fixed prices. At the outbreak of World War II, all lines of piece goods were withdrawn from the market, and the taxpayer had on hand only a six months' supply. Taxpayer several times in the past had purchased wool tops and contracted with manufacturers of wool yarn and cloth to make piece goods from wool tops. During September, 1939, the taxpayer purchased futures contracts calling for the delivery of a year's supply of wool tops in March, 1940. Toward the close of 1939, piece goods were again offered on the market, and the taxpayer learned that the wool tops to be delivered in March were of a grade unsuitable for the manufacture of its piece goods. During February, 1940, the taxpayer sold the futures contracts at a substantial loss. The Tax Court held, and the Court of Appeals affirmed, that this was not a true hedging transaction, and, that therefore, the loss was a capital loss.

The taxpayer in the *Makransky* case was concerned, because of war conditions, with having available a

supply of raw materials "at a price". Petitioner was concerned because of droughts with having available a supply of raw materials "at a price". In neither case was there any insurance, *i. e.*, profit insurance or the fixing of the relationship between the market prices of manufactured goods and raw materials. In neither case was there the maintenance of the balanced market position that produces such insurance. In neither case was there the elimination of speculative risks due to fluctuations in the market price. In neither case was there a hedge. In the *Makransky* case it was so held and that as a consequence Section 117 of the Internal Revenue Code was applicable. Reasoning parallel to that in the *Makransky* case had been applied by the Courts of Appeal in denying taxpayers ordinary losses in *Trenton Cotton Oil Co.* v. *Commissioner*, 147 F. (2d) 33 (6th Cir., 1945), and *Commissioner* v. *Farmers & Ginners Cotton Oil Co.*, 120 F. (2d) 772 (5th Cir., 1941) at the urging of the Commissioner of Internal Revenue. In the instant case, The Tax Court also found that there was no hedge, and the Court of Appeals affirmed this finding. Yet both Courts held that Section 117 was not applicable. These cases cannot be reconciled with the instant case.

Conclusion

The plain fact is that Petitioner's commodity futures had no offsetting relationship or tie to any of its sales commitments. They were not so intended.

The intention was simply to acquire a long futures position (R. 52). Petitioner was buying corn futures when it thought that the circumstances indicated that it was good judgment to buy them. It sold them on the same basis. Petitioner was only protecting itself against a rise in the price of corn. Petitioner had no insurance of profit. It had no balanced position. Consequently it exposed itself gratuitously to a different risk, *i. e.*, of the decline of the price of corn.

The inescapable conclusion is that Petitioner was not hedging.[13] It was the legitimate capitalist referred to in this Court's opinion in *United States* v. *New York Coffee & Sugar Exchange, Inc.*, 263 U. S. 611 (1924), the third type of person who deals in commodity futures, the forgotten man of 66 C. M. 17322 referred to above.

Petitioner therefore respectfully submits:

1. Section 117 is applicable to Petitioner's commodity futures transactions. The statute is specifically addressed to the problem and clearly covers it.

2. Hedging is not a justifiable exception to Section 117. The statute contains no such exception. It is clear and unambiguous. It neither requires nor leaves room for construction or interpretation.

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[13] See *In re Corn Products Refining Company*, 13 Agric. Dec. 1117 (1954), where the Secretary of Agriculture with his expertise in this field, so held upon scrutiny of Petitioner's corn futures transactions of the same nature for later years.

3. Petitioner's transactions did not, in fact, constitute "true hedging," the criterion for the "hedging exception" established by the weight of judicial authority. This was affirmatively found by both The Tax Court and the Court of Appeals. It is clear from the facts.

4. The theories of The Tax Court and the Court of Appeals are both untenable. Whatever theoretical justification there may be for a hedging exception to Section 117, cannot be extended under the theories propounded by the Courts below to the facts in this case.

II

Commodity Futures Transactions are Subject to the Wash Sales Provisions of Section 118 of the Internal Revenue Code.

The Tax Court of the United States and the United States Court of Appeals for the Second Circuit have both declined to apply the so-called "wash sales" provisions of Section 118 of the Internal Revenue Code of 1939 to transactions in commodity futures. The direct conflict between the Second Circuit and the Sixth Circuit in *Trenton Cotton Oil Co. v. Commissioner*, 147 F. (2d) 33; (6th Cir., 1945) has already been noted in the opinion below (R. 297).

The basic purpose of Section 118 is to eliminate the use of "paper losses" by denying a taxpayer the right to claim a deduction where, within a thirty-

day period before or after the sale, substantially identical stock or securities have been acquired. This statutory prohibition should apply with equal vigor to both stock and commodity transactions.

Prior to November 24, 1921, losses on sales of securities could be deducted, even though a taxpayer repurchased the same securities on the same day and at the same price as the securities sold. Congress, pointing out the "evasion through the medium of wash sales", in the reports of both its Houses, enacted in the Revenue Act of 1921 the so-called "wash sales" provision disallowing losses on sales of stock or securities where within 30 days before or after the transaction taxpayer acquired substantially identical property. This same provision appeared in Section 118 of the Internal Revenue Code of 1939. The issue in this case turns on the meaning of the word "security".

A. The Meaning of the Term "Security"

The only definition of the word "security" in the Internal Revenue Code of 1939, which is not restricted to securities issued by a corporation, is that appearing in Section 3672(b)(2), which includes not only all corporate and government securities, but any negotiable instrument as well.

This Court has established that the language in the Revenue Acts is to be taken in its ordinary meaning, unless the context or legislative history of the enact-

ment compels a different interpretation. *Old Colony R. R. Co. v. Commissioner*, 284 U. S. 552, 560.

Webster's New International Dictionary defines the word "security" as "an evidence of debt or of property, as a bond, stock certificate, or other instrument, etc.; a document giving the holder the right to demand and receive property not in his possession."

The history of the word "securities" is of some interest. It comes from two Latin words—*se* (without) plus *cura* (care).

Mr. Justice Kekewich's language in the English case, *In re Johnson*, 89 L. T. 84 (1903), has been much quoted in this country:

> "Of course it is well known that 'security' really means something which frees you from care—that is, care as to money which you have invested, the principal and perhaps the interest too—something which frees you from care, and enables you, as regards that particular investment, to be, to use a poetical expression, like 'the gods that live at ease.'"

The word has never become a legal term of art. The concept was originally applied only to mortgage debt by the Courts and did not include stock or unsecured debentures. It was later extended and has come to have the broad meaning appearing in Webster's New International Dictionary, which was adopted in *Tron-*

ton Cotton Oil Co. v. Commissioner, 147 F. (2d) 33 (6th Cir. 1945), where the Court said:

> "It may be that when petitioner sold futures contracts and repurchased others of a like amount there was a constructive delivery of the cottonseed oil to petitioner and a constructive re-delivery to the broker, but considering the substance of the transactions rather than their form petitioner had no more than a document giving it the right to demand and receive property not in its possession. This is a security."

This Court has said, in construing the term "securities", that "courts will construe the details of an act in conformity with its dominating general purpose, will read text in the light of context and will interpret the text so far as the meaning of the words fairly permits so as to carry out in the particular cases the generally expressed legislative policy." (*Securities and Exchange Commission* v. *Joiner Leasing Corp.*, 320 U. S. 344, 350-351 (1943)).

We have pointed out that the evidence in this case shows that a corn futures contract dealt with on a regulated exchange consists of a document (Exhibits 14 and 15, R. 89 and 151, 90 and 152) evidencing a right to buy 5,000 bushels of corn or some multiple thereof, of a stated quality, at a stated price, upon delivery during a stated month in the future, and calls for the actual receipt and delivery of the property

and payment therefor (R. 89, 90, 151, 152). This is clearly a "security" in the generally accepted sense of the term.

In the present case the vast majority of Petitioner's transactions in commodity futures was transacted for it by brokers on the floor of the Chicago Board of Trade (R. 89, 91). This regulated exchange not only lists various commodities, but also stocks and bonds (R. 94). The same broker can buy or sell either commodity futures or stocks and bonds on margin for the same client without leaving the floor of that exchange. Congress must have intended that a taxpayer operating through the same broker on the same exchange should receive the same treatment, as far as "wash sales" are concerned, in the case of commodity futures as in the case of stocks and bonds.

How would Respondent treat "when-issued securities"[14] and "puts" and "calls" which in common with commodity futures, are all papers written by a broker? They are all, in common, negotiable and can be purchased either on margin or for a fraction of the cost of the underlying stock. Transactions in these securities should receive identical treatment, under Section 118, with stocks and bonds. Any other interpretation would allow the deduction of paper losses representing no economic change of position, which the statute was designed to prevent.

[14] This Court in *Chicago Board of Trade* v. *Christie Grain & Stock Company*, 198 U. S. 236, at page 248; likened futures trading to stock trading for future delivery.

In *Trenton Cotton Oil Co. v. Commissioner*, 147 F. (2d) 33 (6th Cir., 1945), the Court of Appeals said at page 37:

> "The sole purpose of the statute was to prevent the deduction of losses from net income and the Congress set up as a barrier a more or less arbitrary standard to overcome the evil. Unless losses from dealings in commodity futures through a broker are within the statute, the barrier is weakened, because the dealings in such property on exchanges of the country is almost as extensive as that in stocks and bonds."

B. The Meaning of the Term "Substantially Identical"

There is one further point with respect to Section 118—the question of whether one commodity future is substantially identical to another. Petitioner's witness, Henry, testified that one commodity contract for 5,000 bushels was identical to any other contract for 5,000 bushels (R. 89, 90). It was not merely substantially identical. All contracts mature within a single year—usually in the months of May, July, December, and occasionally March and October (R. 54). In each case the contract is written by a recognized broker on the floor of a regulated exchange for the benefit of his customer who generally buys on margin. The broker takes the margin and thereafter the contract is sold to the customer of some other broker who also normally buys on margin. The seller or

purchaser, as the case may be, is not known to the other party buying or selling and, consequently, their identities are of no economic significance. The parties accept the Board of Trade responsibility for the commodity brokers. This contract is negotiable and can be sold and resold until maturity. Normally, as in the instant case, settlement is made prior to maturity, so that only in rare instances do the parties take delivery. See *George W. Covington*, 42 B. T. A. 601 (1940); aff. 120 F. (2d) 768 (5th Cir., 1941), cert. denied 315 U. S. 822 (1942).

The case of *Marie Haulin, et al.*, 38 B. T. A. 811 (1938), affirmed 108 F. (2d) 429 (3rd Cir., 1939), discussed at some length the meaning of the word "substantially", with the absolute noun "identical". It compared this term, as used in Section 118, with the corresponding adjective and absolute "substantially all," which appeared in Section 203(h)(i)(A) of the Revenue Act of 1926; and noted that the cases under the reorganization sections held variously that where all or all but 10% or 15% of the property was acquired, the statutory test was met. There is, of course, some small economic difference in the value of different maturities of corn futures within a year on any given day. A reference to the published quotations in the daily newspaper will show, however, that the difference in economic value is well within the 10% or 15% limit set forth in the *Haulin* case.

To hold that under such circumstances commodity futures contracts do not come within the provisions of Section 118 defeats the underlying purpose of the statute and is untenable.

C. Cases Cited Below Are Distinguishable

The cases cited by the Court of Appeals in support of its position that commodity futures are not subject to the "wash sales" provisions do not involve Section 118 or the question of wash sales. *Harriss* v. *Commissioner*, 143 F. (2d) 279 (2nd Cir., 1944); and *Valley Waste Mills* v. *Page*, 115 F. (2d) 466 (5th Cir., 1941), cert. denied 312 U. S. 681.

These cases merely hold that if a commodity contract is disposed of, it is a completed transaction for purposes of computing *gain* and is not a tax-free exchange within the purview of the provisions of Section 112 of the Internal Revenue Code. Section 118 has no reference whatsoever to gains, which are recognized in the year in which they occur. It merely prevents the taking of *paper losses* where there has been no change in economic position. There has never been any contention here by Petitioner, where it closed out a transaction at a profit, that the profit was not recognized at once within the rationale of the two cited cases.

It is respectfully submitted that the corn futures transactions of Petitioner on regulated exchanges

were subject to the "wash sales" provisions of Section 118. To hold otherwise would be to leave the door open to grave abuse.

CONCLUSION

It is urged that for the foregoing reasons the judgment of the Court below should be reversed.

Respectfully submitted,

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JAY O. KRAMER
Counsel for Petitioner

Dated: Aug. 23, 1955.

APPENDIX A

INTERNAL REVENUE CODE OF 1939

SEC. 117. CAPITAL GAINS AND LOSSES (AS AMENDED BY SECS. 212 (a) and (b), 214(c) and 229, REV. ACT 1939).

(a) Definitions.—As used in this chapter—

(1) CAPITAL ASSETS.—The term "capital assets" means property held by the taxpayer (whether or not connected with his trade or business), but does not include stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business, or property, used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 23(l);

(2) SHORT-TERM CAPITAL GAIN.—The term "short-term capital gain" means gain from the sale or exchange of a capital asset held for not more than 18 months, if and to the extent such gain is taken into account in computing net income;

(3) SHORT-TERM CAPITAL LOSS.—The term "short-term capital loss" means loss from the sale or exchange of a capital asset held for not more than 18 months, if and to the extent such loss is taken into account in computing net income;

(4) LONG-TERM CAPITAL GAIN.—The term "long-term capital gain" means gain from the sale or exchange of a capital asset held for more than 18 months, if and to the extent such gain is taken into account in computing net income;

(5) LONG-TERM CAPITAL LOSS.—The term "long-term capital loss" means loss from the sale or exchange of

a capital asset held for more than 18 months, if and to the extent such loss is taken into account in computing net income;

(6) NET SHORT-TERM CAPITAL GAIN.—The term "net short-term capital gain" means the excess of short-term capital gains for the taxable year over the sum of (A) short-term capital losses for the taxable year, plus (B) the net short-term capital loss of the preceding taxable year (if beginning after December 31, 1937), to the extent brought forward to the taxable year under subsection (e);

(7) NET SHORT-TERM CAPITAL LOSS.—The term "net short-term capital loss" means the excess of short-term capital losses for the taxable year over the short-term capital gains for such year;

(8) NET LONG-TERM CAPITAL GAIN.—The term "net long-term capital gain" means the excess of long-term capital gains for the taxable year over the long-term capital losses for such year;

(9) NET LONG-TERM CAPITAL LOSS.—The term "net long-term capital loss" means the excess of long-term capital losses for the taxable year over the long-term capital gains for such year.

(b) Percentage taken into account.—In the case of a taxpayer, other than a corporation, only the following percentages of the gain or loss recognized upon the sale or exchange of a capital asset shall be taken into account in computing net income:

100 per centum if the capital asset has been held for not more than 18 months;

66⅔ per centum if the capital asset has been held for more than 18 months but not for more than 24 months;

50 per centum if the capital asset has been held for more than 24 months.

(c) Alternative taxes.—

(1) In case of net long-term capital gain.—If for any taxable year a taxpayer (other than a corporation) derives a net long-term capital gain, there shall be levied, collected, and paid, in lieu of the tax imposed by sections 11 and 12, a tax determined as follows, if and only if such tax is less than the tax imposed by such sections:

A partial tax shall first be computed upon the net income reduced by the amount of the net long-term capital gain, at the rates and in the manner as if this subsection had not been enacted, and the total tax shall be the partial tax plus 30 per centum of the net long-term capital gain.

(2) In case of net long-term capital loss.—If for any taxable year a taxpayer (other than a corporation) sustains a net long-term capital loss, there shall be levied, collected, and paid, in lieu of the tax imposed by sections 11 and 12, a tax determined as follows, if and only if such tax is greater than the tax imposed by such sections:

A partial tax shall first be computed upon the net income increased by the amount of the net long-term capital loss, at the rates and in the manner as if this subsection had not been enacted, and the total tax shall be the partial tax minus 30 per centum of the net long-term capital loss.

(d) Limitation on capital losses.—

(1) Corporations.—In the case of a corporation, losses from sales or exchanges of capital assets shall be allowed only to the extent of $2,000 plus the gains from such sales or exchanges. If a bank or trust company incorporated under the laws of the United States (including laws relating to the District of

Columbia) or of any State or Territory, a substantial part of whose business is the receipt of deposits, sells any bond, debenture, note, or certificate or other evidence of indebtedness issued by any corporation (including one issued by a government or political subdivision thereof), with interest coupons or in registered form, any loss resulting from such sale (except such portion of the loss as does not exceed the amount, if any, by which the adjusted basis of such instrument exceeds the par or face value thereof) shall not be subject to the foregoing limitation and shall not be included in determining the applicability of such limitation to other losses.

(2) OTHER TAXPAYERS.—In the case of a taxpayer other than a corporation, short-term capital losses shall be allowed only to the extent of short-term capital gains. [See amendment of subsection (d) by section 212(a) of Revenue Act of 1939, set forth below.]

(e) Net short-term capital loss carry-over.—If any taxpayer (other than a corporation) sustains in any taxable year beginning after December 31, 1937, a net short-term capital loss, such loss (in an amount not in excess of the net income for such year) shall be treated in the succeeding taxable year as a short-term capital loss, except that it shall not be included in computing the net short-term capital loss for such year. [See amendment of subsection (e) by section 212(b) of Revenue Act of 1939, set forth below.]

(f) Retirement of bonds, etc.—For the purposes of this chapter, amounts received by the holder upon the retirement of bonds, debentures, notes, or certificates or other evidences of indebtedness issued by any corporation (including those issued by a government or political subdivision thereof), with interest coupons or in registered form, shall be considered as amounts received in exchange therefor.

(g) Gains and losses from short sales, etc.—For the purpose of this chapter—

(1) gains or losses from short sales of property shall be considered as gains or losses from sales or exchanges of capital assets; and

(2) gains or losses attributable to the failure to exercise privileges or options to buy or sell property shall be considered as short-term capital gains or losses.

(h) Determination of period for which held.—For the purpose of this section—

(1) In determining the period for which the taxpayer has held property received on an exchange there shall be included the period for which he held the property exchanged, if under the provisions of section 113, the property received has, for the purpose of determining gain or loss from a sale or exchange, the same basis in whole or in part in his hands as the property exchanged.

(2) In determining the period for which the taxpayer has held property however acquired there shall be included the period for which such property was held by any other person, if under the provisions of section 113, such property has, for the purpose of determining gain or loss from a sale or exchange, the same basis in whole or in part in his hands as it would have in the hands of such other person.

(3) In determining the period for which the taxpayer has held stock or securities received upon a distribution where no gain was recognized to the distributee under the provisions of section 112(g) of the Revenue Act of 1928, 45 Stat. 818, or the Revenue Act of 1932, 48 Stat. 705, or under the provisions of section 371(c) of the Revenue Act of 1938 or this

chapter, there shall be included the period for which he held the stock or securities in the distributing corporation prior to the receipt of the stock or securities upon such distribution.

(4) In determining the period for which the taxpayer has held stock or securities the acquisition of which (or the contract or option to acquire which) resulted in the nondeductibility (under section 118 of this chapter or section 118 of the Revenue Act of 1928, 45 Stat. 826, or the Revenue Act of 1932, 47 Stat. 208, or the Revenue Act of 1934, 48 Stat. 745, or the Revenue Act of 1936, 49 Stat. 1692, or the Revenue Act of 1938, 52 Stat. 503, relating to wash sales) of the loss from the sale or other disposition of substantially identical stock or securities, there shall be included the period for which he held the stock or securities the loss from the sale or other disposition of which was not deductible. [See amendment of subsection (h) by section 214(c) of Revenue Act of 1939, set forth below.]

SEC. 212. CORPORATION CAPITAL LOSSES. (REVENUE ACT OF 1939.)

(a) Limitations.—Section 117(d) of the Internal Revenue Code (relating to limitation on capital losses) is amended to read as follows:

"(d) Limitation on capital losses.—Long-term capital losses shall be allowed; but short-term capital losses shall be allowed only to the extent of short-term capital gains."

(b) Net short-term capital loss carry-over.—Section 117(e) of the Internal Revenue Code (relating to the one-year carry-over of net short-term capital loss) is amended to read as follows:

"(e) Net short-term capital loss carry-over.—If any taxpayer sustains in any taxable year, beginning after

December 31, 1937, in the case of a taxpayer other than a corporation, or beginning after December 31, 1939, in the case of a corporation, a net short-term capital loss, such loss (in an amount not in excess of the net income for such year) shall be treated in the succeeding taxable year as a short-term capital loss, except that it shall not be included in computing the net short-term capital loss for such year."

* * * * * *

SEC. 229. TAXABLE YEARS TO WHICH AMENDMENTS APPLICABLE. (REVENUE ACT OF 1939.)

Except the amendments made by sections 211, 213, 214, 215, 217, 219, 220, 221, 222, 223, 226, 227, and 228, the amendments made by this title to the Internal Revenue Code shall be applicable only with respect to taxable years beginning after December 31, 1939.

SEC. 214. BASIS OF STOCK DIVIDENDS AND STOCK RIGHTS. (REVENUE ACT OF 1939.)

* * * * * *

(c) Determination of period for which held.—Section 117(h) of the Internal Revenue Code (relating to determination of period for which property is held) is amended by adding at the end thereof the following new paragraph:

"(5) In determining the period for which the taxpayer has held stock or rights to acquire stock received upon a distribution, if the basis of such stock or rights is determined under section 113(a)(19)(A), there shall (under regulations prescribed by the Commissioner with the approval of the Secretary) be included the period for which he held the stock in the distributing corporation prior to the receipt of such stock or rights upon such distribution."

(d) Taxable years to which applicable.—The amendments made by subsections * * * (c) shall be applicable to taxable years beginning after December 31, 1938.

* * * * *

SEC. 117. CAPITAL GAINS AND LOSSES [AS AMENDED BY SECS. 212(a)(b), 214(c); REV. ACT 1939; SEC. 115(b), REV. ACT 1941; SECS. 150(a)(b)(c)(d), 151(a)(b)(c), 152, REV. ACT 1942].

(a) DEFINITIONS.—As used in this chapter—

(1) CAPITAL ASSETS.—The term "capital assets" means property held by the taxpayer (whether or not connected with his trade or business), but does not include stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business, or property, used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 23(l), or an obligation of the United States or any of its possessions, or of a State or Territory, or any political subdivision thereof, or of the District of Columbia, issued on or after March 1, 1941, on a discount basis and payable without interest at a fixed maturity date not exceeding one year from the date of issue, or real property used in the trade or business of the taxpayer.

(2) SHORT-TERM CAPITAL GAIN.—The term "short-term capital gain" means gain from the sale or exchange of a capital asset held for not more than 6 months, if and to the extent such gain is taken into account in computing net income;

(3) SHORT-TERM CAPITAL LOSS.—The term "short-

term capital loss" means loss from the sale or exchange of a capital asset held for not more than 6 months, if and to the extent such loss is taken into account in computing net income;

(4) LONG-TERM CAPITAL GAIN.—The term "long-term capital gain" means gain from the sale or exchange of a capital asset held for more than 6 months, if and to the extent such gain is taken into account in computing net income;

(5) LONG-TERM CAPITAL LOSS.—The term "long-term capital loss" means loss from the sale or exchange of a capital asset held for more than 6 months, if and to the extent such loss is taken into account in computing net income;

(6) NET SHORT-TERM CAPITAL GAIN.—The term "net short-term capital gain" means the excess of short-term capital gains for the taxable year over the short-term capital losses for such year;

(7) NET SHORT-TERM CAPITAL LOSS.—The term "net short-term capital loss" means the excess of short-term capital losses for the taxable year over the short-term capital gains for such year;

(8) NET LONG-TERM CAPITAL GAIN.—The term "net long-term capital gain" means the excess of long-term capital gains for the taxable year over the long-term capital losses for such year;

(9) NET LONG-TERM CAPITAL LOSS.—The term "net long-term capital loss" means the excess of long-term capital losses for the taxable year over the long-term capital gains for such year.

(10) NET CAPITAL GAIN.—

(A) Corporations.—In the case of a corporation, the term "net capital gain" means the excess of the

gains from sales or exchanges of capital assets over the losses from such sales or exchanges; and

(B) Other Taxpayers.—In the case of a taxpayer other than a corporation, the term "net capital gain" means the excess of (i) the sum of the gains from sales or exchanges of capital assets; plus net income of the taxpayer or $1,000, whichever is smaller, over (ii) the losses from such sales or exchanges. For purposes of this subparagraph, net income shall be computed without regard to gains or losses from sales or exchanges of capital assets.

(11) Net capital loss.—The term "net capital loss" means the excess of the losses from sales or exchanges of capital assets over the sum allowed under subsection (d). For the purpose of determining losses under this paragraph, amounts which are short-term capital losses under subsection (e)(1) shall be excluded.

(b) Percentage Taken Into Account.—In the case of a taxpayer, other than a corporation, only the following percentages of the gain or loss recognized upon the sale or exchange of a capital asset shall be taken into account in computing net capital gain, net capital loss, and net income:

100 per centum if the capital asset has been held for not more than 6 months;

50 per centum if the capital asset has been held for more than 6 months.

(c) Alternative Taxes.—

(1) Corporations.—If for any taxable year the net long-term capital gain of any corporation exceeds the net short-term capital loss, there shall be levied, collected, and paid, in lieu of the tax imposed by sec-

tions 13, 14, 15, 204, 207(a) (1) or (3), and 500, a tax determined as follows, if and only if such tax is less than the tax imposed by such sections:

A partial tax shall first be computed upon the net income reduced by the amount of such excess, at the rates and in the manner as if this subsection had not been enacted, and the total tax shall be the partial tax plus 25 per centum of such excess.

(2) OTHER TAXPAYERS.—If for any taxable year the net long-term capital gain of any taxpayer (other than a corporation) exceeds the net short-term capital loss, there shall be levied, collected, and paid, in lieu of the tax imposed by sections 11 and 12, a tax determined as follows, if and only if such tax is less than the tax imposed by such sections:

A partial tax shall first be computed upon the net income reduced by the amount of such excess, at the rates and in the manner as if this subsection had not been enacted, and the total tax shall be the partial tax plus 50 per centum of such excess.

(d) LIMITATION ON CAPITAL LOSSES.—

(1) CORPORATIONS.—In the case of a corporation, losses from sales or exchanges of capital assets shall be allowed only to the extent of gains from such sales or exchanges.

(2) OTHER TAXPAYERS.—In the case of a taxpayer, other than a corporation, losses from sales or exchanges of capital assets shall be allowed only to the extent of the gains from such sales or exchanges, plus the net income of the taxpayer of[1] $1,000, whichever is smaller. For purposes of this paragraph, net income shall be computed without regard to gains or losses from sales or exchanges of capital assets.

[1] So in original.

(e) CAPITAL LOSS CARRY-OVER.—

(1) METHOD OF COMPUTATION.—If for any taxable year beginning after December 31, 1941, the taxpayer has a net capital loss, the amount thereof shall be a short-term capital loss in each of the five succeeding taxable years to the extent that such amount exceeds the total of any net capital gains of any taxable years intervening between the taxable year in which the net capital loss arose and such succeeding taxable year. For purposes of this paragraph a net capital gain shall be computed without regard to such net capital loss or to any net capital losses arising in any such intervening taxable years.

(2) RULE FOR APPLICATION OF CAPITAL LOSS CARRY-OVER FROM 1941.—The amount of the net short-term capital loss of the last taxable year beginning in 1941 (computed without regard to amounts treated as short-term capital losses from the preceding taxable year), which is not in excess of the net income for such taxable year, shall, to the extent of the net short-term capital gain for the succeeding taxable year (computed without regard to this paragraph), be a short-term capital loss of such succeeding taxable year.

(f) RETIREMENT OF BONDS, ETC.—For the purposes of this chapter, amounts received by the holder upon the retirement of bonds, debentures, notes, or certificates or other evidences of indebtedness issued by any corporation (including those issued by a government or political subdivision thereof), with interest coupons or in registered form, shall be considered as amounts received in exchange therefor.

(g) GAINS AND LOSSES FROM SHORT SALES, ETC.—For the purpose of this chapter—

(1) gains or losses from short sales of property

shall be considered as gains or losses from sales or exchanges of capital assets; and

(2) gains or losses attributable to the failure to exercise privileges or options to buy or sell property shall be considered as short-term capital gains or losses.

(h) DETERMINATION OF PERIOD FOR WHICH HELD.—For the purpose of this section—

(1) In determining the period for which the taxpayer has held property received on an exchange there shall be included the period for which he held the property exchanged, if under the provisions of section 113, the property received has, for the purpose of determining gain or loss from a sale or exchange, the same basis in whole or in part in his hands as the property exchanged. For the purposes of this paragraph, an involuntary conversion described in section 112(f) shall be considered an exchange of the property converted for the property acquired.

(2) In determining the period for which the taxpayer has held property however acquired there shall be included the period for which such property was held by any other person, if under the provisions of section 113, such property has, for the purpose of determining gain or loss from a sale or exchange, the same basis in whole or in part in his hands as it would have in the hands of such other person.

(3) In determining the period for which the taxpayer has held stock or securities received upon a distribution where no gain was recognized to the distributee under the provisions of section 112(g) of the Revenue Act of 1928, 45 Stat. 818, or the Revenue Act of 1932, 48 Stat. 705, or under the provisions of section 371(c) of the Revenue Act of 1938 or this chapter, there shall be included the period for which

he held the stock or securities in the distributing corporation prior to the receipt of the stock or securities upon such distribution.

(4) In determining the period for which the taxpayer has held stock or securities the acquisition of which (or the contract or option to acquire which) resulted in the nondeductibility (under section 118 of this chapter or section 118 of the Revenue Act of 1928, 45 Stat. 826, or the Revenue Act of 1932, 47 Stat. 208, or the Revenue Act of 1934, 48 Stat. 715, or the Revenue Act of 1936, 49 Stat. 1692, or the Revenue Act of 1938, 52 Stat. 503, relating to wash sales) of the loss from the sale or other disposition of substantially identical stock or securities, there shall be included the period for which he held the stock or securities the loss from the sale or other disposition of which was not deductible.

(5) In determining the period for which the taxpayer has held stock or rights to acquire stock received upon a distribution, if the basis of such stock or rights is determined under section 113(a)(19)(A), there shall (under regulations prescribed by the Commissioner with the approval of the Secretary) be included the period for which he held the stock in the distributing corporation prior to the receipt of such stock or rights upon such distribution.

(6) In determining the period for which the taxpayer has held stock or securities acquired from a corporation by the exercise of rights to acquire such stock or securities, there shall be included only the period beginning with the date upon which the right to acquire was exercised.

(i) Bonds, Etc., Losses of Banks.—For the purposes of this chapter, in the case of a bank, as defined in section 104, if the losses of the taxable year from sales

or exchanges of bonds, debentures, notes, or certificates, or other evidence of indebtedness issued by any corporation (including one issued by a government or political subdivision thereof) with interest coupons or in registered form, exceed the gains of the taxable year from such sales or exchanges, no such sale or exchange shall be considered a sale or exchange of a capital asset.

(j) GAINS AND LOSSES FROM INVOLUNTARY CONVERSION AND FROM THE SALE OR EXCHANGE OF CERTAIN PROPERTY USED IN THE TRADE OR BUSINESS.—

(1) DEFINITION OF PROPERTY USED IN THE TRADE OR BUSINESS.—For the purposes of this subsection, the term "property used in the trade or business" means property used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 23(l), held for more than 6 months, and real property used in the trade or business, held for more than 6 months, which is not (A) property of a kind which would properly be includible in the inventory of the taxpayer if on hand at the close of the taxable year, or (B) property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business.

(2) GENERAL RULE.—If, during the taxable year, the recognized gains upon sales or exchanges of property used in the trade or business, plus the recognized gains from the compulsory or involuntary conversion (as a result of destruction in whole or in part, theft or seizure, or an exercise of the power of requisition or condemnation or the threat or imminence thereof) of property used in the trade or business and capital assets held for more than 6 months into other property or money, exceed the recognized losses from such sales, exchanges, and conversions, such gains and losses shall be considered as gains and losses

from sales or exchanges of capital assets held for more than 6 months. If such gains do not exceed such losses, such gains and losses shall not be considered as gains and losses from sales or exchanges of capital assets. For the purposes of this paragraph:

(A) In determining under this paragraph whether gains exceed losses, the gains and losses described therein shall be included only if and to the extent taken into account in computing net income, except that subsections (b) and (d) shall not apply.

(B) Losses upon the destruction, in whole or in part, theft or seizure, or requisition or condemnation of property used in the trade or business or capital assets held for more than 6 months shall be considered losses from a compulsory or involuntary conversion.

SEC. 118. LOSS FROM WASH SALES OF STOCK OR SECURITIES.

(a) In the case of any loss claimed to have been sustained from any sale or other disposition of shares of stock or securities where it appears that, within a period beginning 30 days before the date of such sale or disposition and ending 30 days after such date, the taxpayer has acquired (by purchase or by an exchange upon which the entire amount of gain or loss was recognized by law), or has entered into a contract or option so to acquire, substantially identical stock or securities, then no deduction for the loss shall be allowed under section 23(e)(2); nor shall such deduction be allowed under section 23(f) unless the claim is made by a corporation, a dealer in stocks or securities, and with respect to a transaction made in the ordinary course of its business.

APPENDIX B

RESEARCH INSTITUTE OF AMERICA, INC.

TAXATION REPORT

May 5, 1955

Sale of Securities Can Give Ordinary Loss

The courts seem to be swinging to the theory that a loss from the sale of a capital asset bought in order to accomplish another business goal is a fully deductible loss. Earlier cases of both the Tax Court and the Second Circuit had held that regardless of why a capital asset was required, any loss on its sale was a capital loss. (*Logan & Kanawha Coal Co.*, 5 T. C. 1298) Thus where a taxpayer had to buy World's Fair bonds in order to obtain a concession, the loss on the bonds was a capital loss. (*Exposition Souvenir Corp.* v. *Com.*, 163 F. (2d) 283)

Later decisions involving stock purchased to acquire scarce merchandise or to escape burdensome contracts have allowed full deductions. And now the Tax Court and the Second Circuit have held that a loss incurred on the sale of bonds which had been acquired for use as security on a contract gave rise to full deduction.

Taxpayer entered into a contract for the manufacture and delivery of machinery. The contract required it to deposit $800,000 in government bonds to guarantee performance. Having no bonds, it borrowed funds from its bank, which purchased the bonds and held them in escrow in accordance with the contract. On completion of the contract, the bonds were immediately sold at a loss.

The Tax Court upheld taxpayer's right to a full deduction for the loss. The bonds were not bought for investment, but solely to carry out a condition imposed by the contract. Their purchase and sale was merely an incident in the carrying on of taxpayer's regular manu-

facturing and selling business. Since taxpayer had no intention of retaining the bonds after they served their business purpose, they were held for sale in the ordinary course of business. The loss on their sale was held to be deductible as "an ordinary and reasonable expense".

The Second Circuit in a 2-1 decision agrees that a business loss is possible even though the loss qualifies as a capital loss. Where a loss is incurred as part of a business contract, the contract is not to be "dissected" into separate parts. (*Bagley and Sewall Co.*, 20 T. C. 983 (NA), aff'd (CA-2) 4/21/55)

observation: Both the Tax Court and the Second Circuit reconciled their latest case with the earlier contrary *Exposition Souvenir Corp.* case on the ground that the World's Fair bonds were held for investment purposes. There the taxpayer was required to make an investment. But this distinction is very weak and it really seems that the courts have basically changed their views.

observation: Dissenting Judge Frank felt that when Congress said that gains or losses from the sales of capital assets were to be taxed in a certain way, it didn't want any gains or losses which so qualified to be taxed differently. He pointed out that while the taxpayer won in this case, other taxpayers may find that gains which qualify as capital gains may be taxed as ordinary income.

observation: If the majority decision is followed, the gates can be opened to considerable litigation on the question of whether a capital gain or loss is really to be treated as a capital gain or loss.

Is Investment the Test of a Capital Asset?

The courts in the *Bagley and Sewall Co.* case above seem to be adopting the view that a capital asset is one which is bought for *investment*. The law on the other

hand, holds that every asset is a capital asset unless it falls into certain specified groups. The key non-capital asset group is "property held *primarily* for sale to *customers* in the ordinary course of his trade or business" (italics added). It's a long stretch from this to hold that a taxpayer must have acquired property for investment in order to have a capital asset.

In a case involving a transaction in foreign exchange, the Tax Court used the argument that an asset bought for "speculation" rather than for investment can't be a capital asset. Church's English Shoes, Ltd., bought shoes in English pounds in 1935. The cost of the shoes was set up at the then current exchange rate for pounds sterling. In 1947 the account payable was satisfied with cheaper pounds sterling. Taxpayer claimed that the difference was a capital gain. The Tax Court ruled that there was a "speculation" in foreign exchange. "Taxpayer . . . did not actually 'invest' in any foreign exchange in 1935, which 'investment' might provide the basis for the capital gain in 1947. . . . When petitioner purchased pounds sterling in 1947, in order to pay at that time its account payable, the purchase of foreign money was no more than a usual and recurring transaction in the ordinary course of its business." The court held that ordinary income resulted. (*Church's English Shoes, Ltd.*, 24 T. C. No. 9)

observation: Under this theory, a person who *speculates* in stocks and bonds could have ordinary income. It's questionable whether the theory will be stretched this far. But the tendency of the court to talk about a class of non-capital assets which are not investment assets (although there is nothing to this effect in the law) raises a new uncertainty in deciding what is a capital asset.